No. 78-1696

In the Supreme Court of the United States

OCTOBER TERM, 1978

DAYTON HYDRAULIC CO., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

WADE H. MCCREE, JR.
Solicitor General
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Washington, D.C. 20530

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The sole question presented in this federal income tax case is whether the decision below correctly held that petitioner, which owned stock in a corporation in the process of liquidating and dissolving, was required to recognize gain on the liquidating distributions where petitioner transferred its stock to another party after the liquidation was substantially complete and immediately prior to the distributions in liquidation.

The pertinent facts are as follows: Petitioner is the successor of another corporation, Frank Hill Smith, Inc. (Hill Smith). During 1967 and 1968, 88.6% of the stock of Hill Smith was owned by the estate of the late Frank Hill Smith. A third corporation, wholly owned by the estate, owned the rest of the Hill Smith stock (Pet. App. 2a).

Hill Smith owned 2,468.25 shares of the Van Cleve Hotel Company (Van Cleve). On October 27, 1967, Van Cleve's shareholders, by the affirmative vote of almost 95% of the outstanding shares, adopted a plan of complete liquidation and dissolution. No objections to the liquidation were recorded. Hill Smith, with 43% of the outstanding Van Cleve shares, could have blocked any rescission of the plan (Pet. App. 2a). On December 29, 1967, Van Cleve completed the sale of its assets, and two days later the purchaser took possession. Van Cleve paid liquidating distributions on January 12, 1968, March 17, 1968, and November 7, 1968 (Pet. App. 3a).

On January 5, 1968, shortly before it would have received the initial liquidating dividend, Hill Smith distributed all of its Van Cleve stock to the estate in redemption of a portion of the Hill Smith shares held by the estate. Seven days later, on January 12, 1968, Van Cleve distributed $370,237.50 to the estate as a liquidating dividend. By the end of 1968, Van Cleve had distributed liquidating dividends to the estate in the total amount of $445,000 (Pet. App. 3a; Pet. 5).

Hill Smith did not report any of the liquidating distributions as income. On audit, the Commissioner of Internal Revenue concluded that Hill Smith's distribution of the Van Cleve shares to the estate was an anticipatory assignment of the liquidation proceeds that Hill Smith was due to receive from Van Cleve. He therefore determined that the liquidating distributions constituted additional income to Hill Smith in 1968 to the extent they exceeded Hill Smith's basis in the Van Cleve stock (Pet. App. 3a).

In this refund suit brought by petitioner, as successor to Hill Smith, in the United States District Court for the Southern District of Ohio, the district court upheld the Commissioner's determination on the basis of the

assignment-of-income doctrine. It held that the substance of the transaction was petitioner's receipt of the Van Cleve liquidation proceeds in return for Van Cleve stock, followed by the transfer of such proceeds to the estate. It therefore concluded that Hill Smith was liable for the tax on the gain on the liquidation (Pet. App. 11a-15a). The court of appeals affirmed (Pet. App. 3a-5a).

1. The decision below correctly held that petitioner was required to recognize gain equal to the amount by which its share of the liquidation proceeds exceeded its basis in the Van Cleve stock. In *Jones* v. *United States*, 531 F. 2d 1343 (6th Cir. 1976) (en banc), the court below held that if a taxpayer transfers stock in a corporation about to be liquidated, when completion of the liquidation is a virtual certainty, the transaction is in substance an exchange of stock for a share of the liquidation proceeds, and the transfer of the liquidation proceeds by the taxpayer. In this respect, the decision is in accord with other courts of appeals that have held the transfer of stock in a liquidating corporation prior to the physical receipt of the liquidation proceeds does not shift the taxation of the gain from the transferor when the "realities and substance" of the transaction are that the liquidation was practically certain to be completed. *Kinsey* v. *Commissioner*, 477 F. 2d 1058, 1062 (2d Cir. 1973); *Hudspeth* v. *United States*, 471 F. 2d 275, 277 (8th Cir. 1972).

In accordance with this unform line of decisions, petitioner is taxable on the gain from the Van Cleve liquidation. When Hill Smith distributed its Van Cleve stock to the estate on January 5, 1968, the liquidation of Van Cleve was assured. The plan of liquidation had been adopted without dissent. Van Cleve already had sold its operating assets and held only cash and receivables. Only seven days later, on January 12, 1968, Van Cleve

distributed more than $370,000 to the estate. Thus, the reality of the transaction was not a transfer of stock in a viable enterprise but rather a shift of a matured right to a pro-rata share of the liquidation proceeds. Under the settled assignment-of-income principles, petitioner cannot deflect the tax on its gain from the liquidation to the estate.[1]

Petitioner argues (Pet. 8-10) that its transfer of Van Cleve stock was no different than a hypothetical transfer of General Motors or other similar publicly traded stock. The cases are not comparable. The ownership of stock in an ongoing corporation represents more than a right to a share of the proceeds of liquidation. To the contrary, a transfer of stock in such a corporation conveys substantial rights to participate in the profits of a going concern. There is accordingly no reason to apply assignment-of-income principles to a transfer of such stock.

2. *General Utilities & Operating Co.* v. *Helvering*, 296 U.S. 200 (1935), upon which petitioner relies (Pet. 10), is not to the contrary. That case held that a corporation that declares a dividend payable in appreciated property is not required to recognize gain upon the distribution of such property. Although the Commissioner argued that the distributing corporation was liable for the gain under assignment-of-income principles, he had not made that argument before the Board of Tax Appeals or in his petition for review of the Board's decision. Accordingly, this Court ruled that the assignment-of-income argument was not properly raised, and that the court of appeals should not have considered it (see 296 U.S. at 206).

[1]There was no realistic possibility that Van Cleve would not liquidate. The Van Cleve plan of liquidation was designed to obtain the benefits of Section 337 of the 1954 Code (Pet. App. 10a). Under that provision, a corporation that undergoes complete liquidation may avoid taxation of the gain on the sale of its assets if it distributes its assets in complete liquidation within the 12-month period following the adoption of the liquidation plan. Thus, if Van Cleve had not completed the liquidation, it would have had to recognize the gain from the sale of its assets.

The *General Utilities* holding was later codified as Section 311(a) of the 1954 Code. See H.R. Rep. No. 1337, 83d Cong., 2d Sess. 37 (1954). Section 311(a) provides that a corporation's distribution of property with respect to its stock does not create taxable gain to the distributing corporation.[2] But it is settled that this general rule does not apply to a case where the recipient of about-to-be distributed income deflects its receipt to a third party. Under such circumstances, assignment-of-income principles require that transferor to include the amount in its gross income. Indeed, the legislative history expressly states that, in enacting Section 311(a), Congress did "not intend to change existing law with respect to attribution of income of shareholders to their corporation as exemplified for example in the case of *Commissioner* v. *First State Bank of Stratford* * * * [168 F. 2d 1004 (5th Cir. 1948), cert. denied, 335 U.S. 867 (1948)]." S. Rep. No. 1622, 83d Cong., 2d Sess. 247 (1954). In *First State Bank of Stratford,* the court held that a bank's distribution to its shareholders of notes, which the bank previously had written off as worthless, was an assignment of income by the bank. The bank was therefore held taxable on the collections received by the shareholders. There is no doubt that neither the *General Utilities* decision nor Section 311(a) supersedes the assignment-of-

[2]In 1969 Congress enacted Section 311(d), which prospectively provided that a corporation recognizes gain when it uses appreciated property to redeem its stock. This amendment does not apply here because the year in question is 1968. See Section 905 of the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487.

income doctrine. See *Williamson* v. *United States*, 292 F. 2d 524, 527-528 (Ct. Cl. 1961); Treasury Regulations on Income Tax, Section 1.311-1(a) (26 C.F.R.).

3. Finally, petitioner argues (Pet. 6-10) that the decision below is contrary to Section 303 of the 1954 Code. That statute provides capital gains treatment to shareholders upon the redemption of corporate stock which was included in a deceased shareholder's gross estate. Property received by a shareholder in a Section 303 redemption is treated as received in exchange for the redeemed stock, rather than as a dividend distribution. But Section 303 applies at the shareholder level. It has no bearing on the question whether a distribution is an assignment of income taxable to the distributing corporation.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

JUNE 1979